Infomail

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Taper Tantrum

What impact has Quantitative Easing (QE) had?

As it seems the global economy becomes more synchronized, as it did in 2008-09, there are times, like now, where it seems to be unsynchronized. Canada seems to be struggling due to China's deceleration. Europe is still in recession but better than it was. The US economy is growing, but at a snail's pace.

The Federal Reserve's large-scale purchases of long term securities most likely provided a moderate boost to economic growth and inflation. The greatest effect came from the Fed's guidance that short term interest rates would remain low for an extended period. With benchmark fed funds rates near zero since 2008, the fed used alternative tools to stimulate the economy. In particular, the Fed purchased large quantities of long term Treasury and mortgage backed securities, the process which became known as Quantitative easing (QE). In November 2010, the Fed announced a program to purchase $600 billion (QE1). In 2012, QE2 was launched, followed by QE3 in late 2012, where the Fed began buying approximately $85 billion in securities a month.

The question now on all participants minds is when the reduction of the size of those purchases, or "tapering," will begin. Some speculate it could be as early as next month (September). With only three Fed FOMC meetings before a new Fed Chair, many argue Bernanke will start the process before stepping down to reduce the pressure on his successor. Since the President has already announced he would be seeking a replacement, Chairman Bernanke may already be a lame duck. With the others who have left or are leaving, that would leave at least four vacancies on the fed Board of Governors, and none of whom were there for the 2007-2008 financial crisis.

The US Federal Reserve is starting to realize that QE doesn't come without risks. It can be argued QE has had some benefits, the economy is better, but it is not growing much faster than a couple of years ago despite trillions, yes trillion, in QE stimulus.

So now the markets are obsessed with "tapering." Once you've had QE all these years, is there a way out via an orderly exit? Managing that exit process may be quite a challenge, especially if the players who orchestrated it at the Fed to begin with are no longer there. Many economists argue QE has depressed interest rates by 100-150 basis points. If QE is removed or "tapered," then that artificial downward pressure on interest rates may be removed as well?

Many are also pointing out that each stage of QE had less of an impact than the previous QE. It is still early in the process, but the financial markets seem to be managing a potential Fed exit and higher bond yields in stride. If the Fed begins "tapering" in September and both the economy and stock market do not fall apart as many individuals fear, confidence will get a boost as the economic recovery would finally be perceived as being able to stand on its own. In fact, the driving force behind the market's run since late last year was not QE, nor earnings growth and certainly not falling interest rates, but rather rising confidence that things <u>were</u> getting better.

So what does this mean for investors? There seems to be a disconnect between theory (what "should" happen) and evidence.

Remember, 10 year US bond yields soared in late 2009 to early 2010 despite the Fed's first round of QE. It wasn't the death of the economy; it was actually the signal the economy was recovering. Higher yields accompany higher growth.

In my opinion, the recent sell off in equities have been driven by an increase in uncertainty around "tapering." We all know equity markets hate uncertainty. But in my view, "tapering," because of an improving economy, will end up being a good thing (like the analogy of taking the training wheels off).

The worst that can happen is they "taper" and the economy starts to slide. They will be back to more stimulus. So it's heads you win, tails you win.

With confidence beginning to return, we should see stronger economic growth emerge, despite the lack of any fiscal stimulus out of Washington.

Stay tuned,

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